INDEX

	Page
Opinions below	1
Jurisdiction	2
Questions presented	2
Statutes and regulations involved	3
Statement	3
Introduction and summary of argument	5
Argument:	
I. The dichotomy between cash and accrual method ranchers is supported by sound accounting practice and by history and has been approved by Congress	8
II. There is no merit to respondents' claim that they have a right to use a hybrid accounting system because they elected the accrual method before the advent of capital gains on breeding animals	18
III. The unit-livestock-price variant of the accrual method of accounting is an acceptable method of computing the amount of raising costs which are to be deferred pending sale of the animals	25
Conclusion	33
Appendix	34

CITATIONS

Cases:

Albright v. *United States*, 173 F. 2d 339	13
American Can Co. v. *Commissioner*, 317 F. 2d 604, certiorari denied, 375 U.S. 993	21
Banks v. *Commissioner*, 322 F. 2d 530	9, 24
Boehm v. *Commissioner*, 326 U.S. 287	16
Brewster v. *Gage*, 280 U.S. 327	16
Broida, Stone & Thomas, Inc. v. *United States*, 309 F. 2d 486, affirming *per curiam* 204 F. Supp. 841	21

CASES—continued

Page

Brown v. *Helvering*, 291 U.S. 193 22
Carter v. *Commissioner*, 257 F. 2d 595 .....9, 10, 21
Commissioner v. *Hansen*, 360 U.S. 446 .....22, 24
Commissioner v. *O. Liquidating Corp.*, 292 F. 2d 225, certiorari denied, 368 U.S. 898 21
Doyle v. *Mitchell Brothers Co.*, 247 U.S. 179 ..... 5, 6
Ezo Products Co. v. *Commissioner*, 37 T.C. 385 25
Frost v. *Commissioner*, 28 T.C. 1118 9
Gibbs v. *Commissioner*, 33 T.C. 27 .....9, 31
Helvering v. *Winmill*, 305 U.S. 79 16
Irvine v. *United States*, 212 F. Supp. 937 .....9, 21
Iverson's Estate v. *Commissioner*, 255 F. 2d 1, certiorari denied, 358 U.S. 893 24
J. A. Biewer Estate v. *Commissioner*, 341 F. 2d 394 25
Little v. *Commissioner*, 34 T.C. 156, affirmed, 294 F. 2d 661 31
Little v. *Commissioner*, 294 F. 2d 661 .....9, 18, 20
Niles Bement Pond Co. v. *United States*, 281 U.S. 357 24
Pacific National Co. v. *Welch*, 304 U.S. 191 24
Scofield v. *Lewis*, 251 F. 2d 128 .....4, 9, 10
Snyder v. *Commissioner*, 295 U.S. 134 6
SoRelle v. *Commissioner*, 22 T.C. 459 .....9, 24
Spring City Co. v. *Commissioner*, 292 U.S. 182 6
Tee Bar Ranch Co. v. *United States* (D. Mont.), decided August 2, 1963 (63-2 U.S.T.C., par. 9663) 9
United States v. *Bennett*, 186 F. 2d 407 13
United States v. *Ekberg*, 291 F. 2d 913, certiorari denied, 368 U.S. 920 .....9, 20
Visintainer v. *United States*, 301 F. 2d 312, affirming *per curiam* 191 F. Supp. 425 9
Wright Contracting Co. v. *Commissioner*, 316 F. 2d 249 21

Statutes:

Internal Revenue Code of 1954:

§ 263 (26 U.S.C. 263) 10
§ 446(e) (26 U.S.C. 446(e)) 3, 20, 34
§ 1001 (26 U.S.C. 1001) 5, 6, 10, 22, 31, 34
§§ 1011-1013 (26 U.S.C. 1011-1013) 22, 31
§ 1012 (26 U.S.C. 1012) 3, 5, 10, 34
§ 1013 (26 U.S.C. 1013) 3, 6, 10, 34
§ 1016 (26 U.S.C. 1016) 3, 5, 10, 31, 35
§ 1231 (26 U.S.C. 1231) 4, 5, 6, 13, 15, 22, 35

Revenue Act of 1951, c. 521, 65 Stat. 452, 501, Sec. 324 ....13, 22

Miscellaneous: Page

98 Cong. Record, Part 6, pp. 8307-8308 .....10, 12, 14, 15, 23
H.R. 3896, 83d Cong., 1st Sess. 15
H. Rep. No. 586, 82d Cong., 1st Sess., p. 32 (1951-2 Cum. Bull. 357, 380) 15, 22
I.T. 3666, 1944 Cum. Bull. 270 .....13, 14, 22, 30
I.T. 3712, 1945 Cum. Bull. 176 .....13, 14, 32
Letter Ruling (unpublished) 1945 CCH Fed. Tax Service, Vol. 4, Para. 6129 25
Mim. 5790, 1945 Cum. Bull. 72 .....26, 27, 30, 32
Mim. 6660, 1951-2 Cum. Bull. 60 14
S. Rep. No. 781, 82d Cong., 1st Sess., p. 42 (1951-2 Cum. Bull. 458, 488) 14, 22
T.D. 5423, 1945 Cum. Bull. 70 26

Treasury Regulations 65 (1924 Revenue Act):
Art. 38 .....10, 11
Art. 111 .....10, 11
Art. 1616 .....10, 11

Treasury Regulations on Income Tax (1954 Code):
§ 1.61-4 (26 C.F.R., § 1.61-4) 3, 8, 9, 10, 26, 28, 29, 30, 32, 36
§ 1.162-12 (26 C.F.R., § 1.162-12) 3, 9, 10, 28, 29, 30, 38
§ 1.167(a)-6 (26 C.F.R., § 1.167(a)-6) 3, 26, 32, 39
§ 1.263(a)-2 (26 C.F.R., § 1.263(a)-2) 5, 10
§ 1.446-1 (26 C.F.R., § 1.446-1) 3, 20, 22, 25, 39
§ 1.471-1 (26 C.F.R., § 1.471-1) 10
§ 1.471-6 (26 C.F.R., § 1.471-6) 3, 8, 10, 26, 27, 30, 32, 40
§ 1.703-1 25
§ 1.1016-2 (26 C.F.R., § 1.1016-2) 10

In the Supreme Court of the United States

OCTOBER TERM, 1965

No. 535

UNITED STATES OF AMERICA, *Petitioner*

v.

JOHN CATTO, JR. AND ROXANA CATTO

UNITED STATES OF AMERICA, *Petitioner*

v.

W. H. WARDLAW, Independent Executor of the Estate of C. W. Wardlaw, Deceased, et al.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The district court did not file an opinion. Its findings of fact and conclusions of law in *Catto* (R. 34-43) are reported at 223 F. Supp. 663, and in *Wardlaw* (R. 50-64) at 223 F. Supp. 631. The respective *per curiam* opinions of the court of appeals (R. 46-48, 104-106) are reported at 344 F. 2d 227 and 344 F. 2d 225.

JURISDICTION

The judgments of the court of appeals were entered on April 8, 1965 (R. 49, 107-108). Mr. Justice Black extended the time for filing a petition for a writ of certiorari to and including September 5, 1965 (R. 108-111). The petition for a writ of certiorari was filed on September 3, 1965, and granted on November 22, 1965 (R. 112). This Court has jurisdiction under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

Ranchers are, in general, entitled to capital gain treatment on profits from the sale of breeding livestock which they use to produce animals marketed for purposes of slaughter. Long standing Treasury Regulations require taxpayers who (like those involved in the instant cases) use the accrual method of accounting to capitalize the costs of raising breeding livestock and then to report as capital gain the excess of the animals' sales proceeds over their accumulated cost basis. Respondents consistently complied with these regulations, but subsequently brought suits for refunds claiming the right (1) to deduct against ordinary income all of the costs of raising their breeding animals, thus giving them a zero cost basis in the livestock and (2) to report the full proceeds of sale as capital gain. The questions presented are:

1. Whether, contrary to Treasury Regulations, ranchers using the accrual method of accounting may transform ordinary income into capital gain by deducting against current income the cost of raising breeding livestock and then reporting the entire proceeds from their sale as capital gain.

2. Whether a court may permit taxpayers to revise materially their consistent method of reporting income by adopting a hybrid accounting system, when those taxpayers did not first make application to the Commissioner for permission to change their method of accounting as required by the Internal Revenue Code of 1954, § 446(e).

STATUTES AND REGULATIONS INVOLVED

Sections 446(e), 1001(a), 1012, 1013, 1016(a)(1), and 1231 (a) and (b)(3) of the Internal Revenue Code of 1954, and Sections 1.61-4, 1.162-12, 1.167(a)-6(b), 1.446-1(e)(2)(i), and 1.471-6 of the Treasury Regulations (1954 Code), appear in the Appendix, *infra*, pp. 33-42.

STATEMENT

The pertinent facts in both suits were stipulated and are substantially the same. For the most part, it will be unnecessary to distinguish between them. Respondents are ranchers who raise livestock for sale.[1] As an incident of this business they also raise breeding cattle which they use to produce beef animals. Each of the respondents elected to report his income on a variant of the accrual method of accounting, called the

[1] Eight cases were consolidated for trial in *United States* v. *Wardlaw;* that case and *United States* v. *Catto,* have been consolidated herein. The years involved vary from case to case, but cover 1954 through 1959, inclusive (R. 6, 35, 54). The various respondents raise cattle, sheep and goats (R. 36, 55). The legal principles are the same regardless of which animals are involved. For simplicity, we will refer to them all as cattle; the term "beef animals" or "beef cattle" refers to livestock which are marketed for purposes of slaughter, while the term "breeding animals" or "breeding cattle" will be used to designate livestock used to produce the beef animals.

unit-livestock-price method. This method permits the rancher to use estimates in lieu of the actual cost of raising cattle for purposes of valuing cattle on hand at the end of the tax year. As required by the Regulations, respondents consistently used this estimated-cost method of accounting for both the beef and breeding cattle which they raised. (R. 2-4, 36-38, 56-58.)

During the years here in question, respondents sold some animals which they had held for breeding purposes for more than 12 months and reported the profit as capital gain under Section 1231 of the 1954 Code. They computed their gain on these sales by deducting from the sales proceeds the cost basis of the breeding cattle sold (calculated according to respondents' estimated-cost method of accounting). However, they subsequently filed claims for refund, contending that they should not have capitalized the cost of raising their breeding cattle. They claimed (1) that the entire accumulated cost of the breeders should be deducted against ordinary income, thus giving them a zero cost basis in the cattle, and (2) that the entire proceeds from the sale of breeding cattle should be treated as capital gain. At no time had respondents requested the Commissioner's permission to change their method of accounting. The Commissioner rejected the refund claims. (R. 38-39, 58-59.) Respondents then sued for a refund and the district court rendered judgment in their favor. (R. 39, 43, 59, 100.) The Fifth Circuit affirmed *per curiam* on the authority of its earlier decision in *Scofield* v. *Lewis,* 251 F. 2d 128, and held invalid the Treasury Regulation requiring ranchers on the unit-livestock-price method of accrual accounting to accumulate the estimated cost of raising breeding cattle (R. 46-48, 104-106).

INTRODUCTION AND SUMMARY OF ARGUMENT

A taxpayer who incurs an expenditure in the course of earning income is normally entitled to offset that expenditure against income on his tax return. There are, however, two questions to be resolved with respect to each such expenditure. One is the timing of the deduction and the other is the type of income against which the expenditure is to be offset.

For example, let us assume that a taxpayer who is in the business of manufacturing steel products expends $10,000 in building and installing a new punch press for use in manufacturing the steel products he sells. He would not be permitted an immediate deduction for this expenditure. Instead, he would be required to defer these costs (which would thereafter be called the punch press' basis). If, because of a change in his business, the taxpayer sold the punch press the next year, the deferred cost of building the machine ($10,000 less any depreciation deducted in the meantime) would be offset against the proceeds of sale in computing the gain or loss on the transaction. If the gain from the sale constituted capital gain, the deferred cost of building the machine would reduce the amount of capital gain; if the gain from the transaction constituted ordinary income, the deferred costs would reduce ordinary income. 1954 Code §§ 1231, 1001, 1012, 1016, 263; Treas. Reg. § 1.263(a)-2(a); *Doyle* v. *Mitchell Brothers Co.*, 247 U.S. 179.

Similarly, if the same taxpayer expends $5000 in manufacturing steel products (his normal inventory items), and at the end of his tax year these steel products are still on hand, he is not entitled to a deduction for such costs, but must defer them until the items are sold. When he sells the inventory, he may offset

the accumulated costs (*i.e.*, the inventory's basis) against the proceeds from its sale. 1954 Code § 1001, 1013. See *Doyle* v. *Mitchell Brothers Co., supra; Spring City Co.* v. *Commissioner,* 292 U.S. 182, 185; *Snyder* v. *Commissioner,* 295 U.S. 134, 141 n. 4.

Respondents are all in the business of raising and selling cattle for slaughter. As an incident of this business, they also raise breeding animals which they use to produce beef cattle. It is clear that respondents' profits on the sale of beef animals are taxed as ordinary income (the same as a manufacturing enterprise's profits on sales of its inventory) and that respondents' profits on the sale of breeding animals held for one year or more are taxed as capital gains (like an industrial concern's profits on sale of machinery and equipment).[2] 1954 Code § 1231(b)(3). It is also undisputed that respondents—all of whom have elected the accrual method of accounting—must defer the costs of raising their *beef* cattle and offset these accumulated costs against the proceeds when the animals are sold. The sole question here in dispute is whether respondents must also defer the costs of raising their *breeding* animals and offset these accumulated costs (less de-

[2] Actually profits of this nature are taxed under 1954 Code § 1231 which requires a taxpayer to combine all of his gains and losses from the disposition of certain assets, such as plant and equipment, and if the net result is a gain, provides that it shall be taxed as a capital gain, but if the net result is a loss, provides that it shall be treated as an ordinary loss. It is, of course, to the taxpayer's advantage to treat his net profit as a capital gain and his net loss as an ordinary loss. Therefore, § 1231 treatment is even more advantageous for the taxpayer than straight capital asset treatment (where both net gains and net losses are capital in nature). For simplicity, breeding cattle will be referred to herein as a capital asset, although, technically speaking, they are § 1231 assets.

preciation, if any) against the proceeds when the breeding animals are ultimately sold.

The basic Regulations dealing with methods of accounting for farmers and ranchers were adopted in 1924. They afford farmers and ranchers a choice between a simple cash method of accounting under which they deduct the costs of raising their crops and animals as incurred and a more sophisticated accrual method under which they accumulate such costs and deduct them against the proceeds realized upon sale of the crops or animals. Although respondents elected the accrual method of accounting, they now claim that changes in the tax treatment of profits realized on disposition of breeding cattle entitle them to unilaterally adopt a hybrid method of accounting without requesting permission from the Commissioner, *i.e.,* to use the accrual method of accounting for beef animals and the cash method for breeding animals.

We will show in Point I that cash method ranchers and farmers are permitted to deduct the costs of raising their crops and animals only because their practical circumstances make it advisable that they be offered an extremely simple method of accounting; and in Point II that Congress has expressly recognized that taxpayers, like respondents, who have rejected bookkeeping simplicity for accounting accuracy by electing the accrual method are not entitled either to revoke their election and switch to the cash method or to adopt a hybrid method of accounting embodying the advantages of both systems without the disadvantages of either.

In Point III, we will show that the unit-livestock-price method of valuing inventory (elected by all respondents) is one acceptable method of deferring the costs attributable to raised cattle until they are sold.

Regardless of the terminology used, the practice of including breeders in inventory does not prevent respondents from reporting the profits from the sale of raised breeders as capital gain. It merely requires them to accumulate the costs of raising breeders and offset such costs against the proceeds of sale in computing the amount of capital gain. Thus, the mechanics of the unit-livestock-price variant of the accrual method are completely in harmony with the relevant Code provisions discussed in Points I and II.

ARGUMENT

I.

The Dichotomy Between Cash and Accrual Method Ranchers is Supported by Sound Accounting Practice and by History and Has Been Approved by Congress.

The essence of respondents' complaint and the lower courts' holding is that ranchers who have elected the accrual method of accounting are being treated differently from ranchers who have chosen the cash receipts and disbursements method of accounting. Accrual method taxpayers are required to defer the costs of raising both breeding and beef animals and to offset the accumulated costs of such animals against the proceeds from their eventual sale in computing gains (which in the case of beef cattle is ordinary income and in the case of breeding animals is capital gain). Treas. Reg. §§ 1.61-4(b), 1.471-6.[3] Cash method taxpayers, on the other hand, are permitted to deduct each year the costs incurred in raising cattle (both beef and breeding); they thus accumulate no cost basis for the animals and upon sale the entire proceeds constitute gain

[3] Unless otherwise indicated, citations to Treasury Regulations refer to those under the 1954 Code.

(ordinary income in the case of beef cattle and capital gain in the case of breeders). Treas. Reg. §§ 1.61-4(a), 1.162-12. Therefore, taxpayers on the cash method of accounting deduct the costs of raising breeding cattle against ordinary income while accrual method ranchers deduct the costs of raising breeders against the capital gain received upon the sale of such animals. Respondents argue that, although they elected the accrual method of accounting for their ranching operations, they should nevertheless be permitted, contrary to the Treasury Regulations and the Commissioner's settled practice, to deduct the costs of raising breeding cattle against ordinary income, as are cash method taxpayers. We submit that this long-standing dichotomy in treatment between cash and accrual ranchers is supported by sound accounting practice and by history and has been approved by Congress. The lower court erred, therefore, in holding the Regulations invalid.[4]

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[4] All of the other courts to consider this question have agreed with the government. See *Little* v. *Commissioner*, 294 F. 2d 661 (C.A. 9); *United States* v. *Ekberg*, 291 F. 2d 913 (C.A. 8), certiorari denied, 368 U.S. 920; *Visintainer* v. *United States*, 301 F. 2d 312 (C.A. 10); affirming *per curiam* 191 F. Supp. 425 (D. Colo.); *Banks* v. *Commissioner*, 322 F. 2d 530 (C.A. 8); *Irvine* v. *United States*, 212 F. Supp. 937 (D. Wyo.); *Tee Bar Ranch Co.* v. *United States*, (D. Mont.), decided August 2, 1963 (63-2 U.S.T.C. par. 9663); *Gibbs* v. *Commissioner*, 33 T.C. 27; *Frost* v. *Commissioner*, 28 T.C. 1118; *SoRelle* v. *Commissioner*, 22 T.C. 459.

Indeed, the Fifth Circuit expressed misgivings about the result it felt itself compelled by *stare decisis* to reach in the instant cases. The Fifth Circuit first considered the question presented here in *Scofield* v. *Lewis*, 251 F. 2d 128, and decided against the government. Shortly thereafter, it cast doubt on the validity of that decision by stating that "the principle of the *Lewis* case should not be extended beyond its own facts." *Carter* v. *Commissioner*, 257 F. 2d 595, 600. Nevertheless, in its *per curiam* opinions in the instant cases, the Fifth Circuit felt bound to adhere to *Scofield* v. *Lewis* without reexamination "until its legislative

A. The basic regulations which created this dichotomy between cash and accrual farmers and ranchers were promulgated at least as early as 1924. See Regulations 65, Arts. 38, 111, 1616 (1924 Revenue Act). Compare 1954 Treas. Reg. §§ 1.61-4, 1.162-12, 1.471-6 (1954 Code).

Although most taxpayers who incur expenses in manufacturing an item, whether it be inventory or a capital asset, have always been required to accumulate their costs of production and offset them against the proceeds of sale in computing gain, even if they are on the cash method of accounting,[5] the Commissioner concluded, for a number of reasons, that he should make an even simpler method of accounting available to farmers and ranchers.[6] A farm or ranch was typically a family operation, located far from any urban population center. The small size of most farming operations and their location made it impractical to obtain the services of professional accountants. Thus, the family members and their employees usually main-

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or judicial demise" (R. 48; see also R. 105). However, it expressed reluctance at following this course of action for 5 reasons: (1) the government had presented "impressive conceptual arguments [which were] perhaps not fully advanced [in *Lewis*]," (2) "express rejection of *Lewis* by the 8th and 9th Circuits" had "generated" "doubts" as to that decision's correctness, (3) even "this Court [in *Carter*] has severely limited * * * [*Lewis'*] applicability," (4) the court was "fully cognizant of the anomaly of allowing such tax treatment of a capital asset" as is requested by respondents, and (5) the decision in favor of the taxpayers "results in an inordinate deduction against ordinary income in the year in which the correction is made" (R. 48, 105).

[5] See 1954 Code §§ 263, 1001, 1012, 1013, 1016; Treas. Reg. §§ 1.263(a)-2(a), 1.471-1, 1.1016-2(a).

[6] See Letter of June 27, 1952, from the Secretary of the Treasury to the Chairman of the Senate Finance Committee, 98 Cong. Rec., Pt. 6, pp. 8307-8308, reprinted R. 9-15 (hereinafter referred to as 1952 Letter to Congress).

tained the business records and prepared the tax returns. As a rule, these individuals were unfamiliar with the complexities of an accrual system of accounting. Moreover, the nature of farming and ranching operations made an effective accrual system of accounting difficult to operate. Each employee almost invariably worked on numerous phases of the farm's profit-making endeavors, such as planting and harvesting crops, raising livestock, repairing fences and barns, etc. Thus, it was exceedingly difficult to allocate salaries and the other expenditures among the various farming operations. Consequently, as early as 1924 the Treasury Regulations created a simplified cash method of accounting for farmers and ranchers, under which they were permitted to deduct their expenditures for raising crops and animals as incurred. Regulations 65, Arts. 38, 111 (1924 Revenue Act).

However, the Commissioner recognized that the income of a farm or ranch, just as that of an industrial concern, would be more accurately reported if the costs of raising crops or animals were accumulated until the crops or animals were sold and deducted against the sales proceeds to determine the profit or loss on the transaction as a whole.[7] Therefore, the Treasury Regulations have since 1924 permitted farmers and ranchers to choose the more sophisticated accrual method of accounting, under which they are required to accumulate the costs of raising crops and animals and offset them against sales proceeds. Regulations 65, Arts. 38, 1616 (1924 Revenue Act).

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[7] Because taxpayers on the cash method frequently deduct the expenses of raising crops or livestock in one year but do not sell them until a later year, the cash method often results in a bunching of income and an inaccurate matching of income with expenses.

Consequently, in keeping with their needs, the Regulations have for more than forty years given ranchers and farmers the widest possible choice between a simple cash method of accounting on the one hand and a more sophisticated accrual system of accounting on the other.

B. As explained, *supra,* p. 5, there are two basic questions with regard to the deductibility of each business expenditure: the tax period in which it is to be deducted, and the type of income against which it is to be offset. Permitting a cash method rancher to deduct the costs of raising *beef* animals as incurred, instead of requiring him to accumulate these costs and offset them against the proceeds from the sale of the animals, affects only the first of these questions, *i.e.,* the tax period in which the expenditure is to be deducted. Since the gain from sales of beef animals is ordinary income, the expenditure would offset ordinary income regardless of whether it is deducted in the year incurred or accumulated and deducted against the proceeds of sale in computing gain.

Moreover, when the Regulations creating the cash and accrual methods of accounting for ranchers were promulgated in 1924, it was thought that the proceeds from sales of breeding cattle also constituted ordinary income. 1952 Letter to Congress, R. 10. Thus, in permitting a cash method rancher to deduct the costs of raising breeders as incurred, the Commissioner believed that he was affecting only the tax period in which the deduction would be allowed and not the type of income against which it would be offset. However, in 1944 the Commissioner ruled for the first time that profits from the sales of raised breeders could constitute

capital gains.[8] Although the Commissioner attempted to restrict the class of breeders that would be subject to capital gains,[9] the courts soon held that virtually all breeders were (like an industrial concern's machinery and equipment) entitled to capital gain treatment.[10] In 1951 Congress explicitly codified the judicial decisions. See Revenue Act of 1951, c. 521, 65 Stat. 452, 501, Sec. 324; now 1954 Code § 1231(b)(3).[11]

When profits on the sale of raised breeding animals began to be taxed as capital gains, cash method taxpayers automatically received an additional tax advantage. No longer did their right to deduct the costs of raising breeders as incurred merely affect the timing of the deduction. Thereafter, it also affected the type of income against which the expenditures would be offset. By deducting the expenses of raising breeders against ordinary income as incurred instead of against the capital gain derived upon sale of the breeders, cash method ranchers were able to reduce their ordinary income and replace it with a corresponding increase in capital gain; this produced a tax saving because ordinary income is taxable at higher rates than capital gain.

At this point the Secretary of the Treasury and the Commissioner of Internal Revenue examined the feasibility of amending the regulations to require cash basis ranchers to accumulate the costs of raising breeders. However, their detailed study of the 1951 statutory

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[8] I.T. 3666, 1944 Cum. Bull. 270.

[9] See I.T. 3666, *supra;* I.T. 3712, 1945 Cum. Bull. 176.

[10] See, *e.g., Albright* v. *United States,* 173 F. 2d 339 (C.A. 8); *United States* v. *Bennett,* 186 F. 2d 407 (C.A. 5).

[11] Congress did, however, extend from 6 to 12 months the period a taxpayer must hold the animals in order to get capital gain treatment. *Ibid.*

amendment's legislative history convinced them that Congress had precluded such a fundamental change in the cash method of accounting. 1952 Letter to Congress, R. 14. Since 1924 the Treasury Regulations had required accrual method ranchers to accumulate the costs of raising cattle while permitting cash method ranchers to deduct such costs as incurred. Between 1924 and 1951 the Code had been frequently reenacted. Moreover, when the Commissioner, in 1944, first ruled that raised breeders qualified for capital gain treatment under certain circumstances, he specifically noted that under the long-accepted farm and ranch accounting methods cash basis taxpayers would deduct the expenses of raising breeders against ordinary income as incurred and report the entire proceeds from sale as capital gain while accrual method ranchers would, like taxpayers in other industries, accumulate the costs of raising breeders and offset them against the proceeds of sale in order to compute gain. I.T. 3666, 1944 Cum. Bull. 270; I.T. 3712, 1945 Cum. Bull. 176.[12] When Congress amended the Code in 1951 to explicitly confirm that breeders were subject to capital gain treatment, both Committee Reports emphasized that the amount of the capital "gains from sales of [breeding] livestock should be computed in accordance with the method of livestock accounting used by the taxpayer and *presently* recognized by the Bureau of Internal Revenue." S. Rep. No. 781, 82d Cong., 1st Sess., p. 42 (1951-2 Cum.

[12] While I.T. 3666 and I.T. 3712 were revoked in 1951 (Mim. 6660, 1951-2 Cum. Bull. 60), this action was taken only because the courts had uniformly rejected the portions of the rulings limiting the circumstances under which raised breeders would qualify for capital gain. It is clear that the revocation was not intended to modify the Treasury's well accepted rules regarding accumulation of raising costs which are embodied in the Regulations. See 1952 Letter to Congress, R. 9-12.

Bull. 458, 488); H. Rep. No. 586, 82d Cong., 1st. Sess., p. 32 (1951-2 Cum. Bull. 357, 380) (emphasis added). This language unmistakably reflects Congress' awareness that two accounting methods were being used to compute gains on sales of breeding livestock. Congress clearly did not intend the 1951 amendment to alter the computation of gain.

Examination of this legislative history convinced the Secretary of the Treasury that Congress wished to continue the long-standing dichotomy between cash and accrual ranchers. (1952 Letter to Congress, R. 14.) Therefore, in 1952 the Secretary of the Treasury asked Congress to withdraw some of the cash systems' basic simplicity by enacting legislation requiring cash method ranchers to accumulate the costs of raising breeders and offset them against the capital gain proceeds realized upon sale. (1952 Letter to Congress, R. 14-15.) Opposing interests, however, introduced a bill to extend to accrual method ranchers the right to deduct against ordinary income the production costs of breeding livestock. H.R. 3896, 83rd Cong., 1st Sess. (1953). Congress did not adopt either solution to the problem. In fact, two years later when the 1954 Code was enacted, the provision for breeding cattle was retained verbatim (as 1954 Code § 1231).

While the Treasury Department has thus far been unsuccessful in withdrawing this tax advantage from the cash method rancher, it does not follow that an accrual method livestock rancher must be allowed the same windfall. The accrual method results in a correct computation of income, while the cash method causes an understatement of income. (1952 Letter to Congress, R. 11-13.) For example, if it costs $100 to raise a breeder which is ultimately sold for $150, a taxpayer

should have a gain of $50. Under the accrual method a rancher would have a $50 capital gain in such circumstances. However, a cash method rancher would be entitled to deduct the $100 of raising costs against ordinary income as incurred and then would have a $150 capital gain upon sale of the animal. Since a taxpayer can elect to be taxed on one-half of his capital gain, the cash rancher obtains a $100 deduction for the raising costs and only $75 of income upon sale (½ of $150). Thus the cash rancher is taxed as if he had suffered a $25 loss on the transaction.

The cash method rancher is reluctantly allowed this tax advantage only because deduction of raising costs as incurred is a necessary concomitant of his simplified method of accounting. This reasoning does not extend to the accrual rancher, who has elected a more sophisticated system of accounting under which expenses are deferred and matched with the income which they produce. Moreover, the legislative history and statutory reenactment which prevent the Treasury from amending the Regulations relating to cash method ranchers also give the effect of law to the Regulations requiring accrual method ranchers to capitalize the costs of raising breeding animals. *Brewster* v. *Gage,* 280 U.S. 327, 337; *Helvering* v. *Winmill,* 305 U.S. 79, 83; *Boehm* v. *Commissioner,* 326 U.S. 287, 291-292.

C. The Fifth Circuit, in the instant cases, did not disagree with the Commissioner's contention that the Regulations created two rational methods of accounting which adequately meet the needs of the farming and ranching communities. Nor did the court find that respondents, all of whom had elected the accrual method of accounting, were being treated unfairly vis-à-vis accrual method taxpayers in other industries.

Rather, the lower court held the long standing Treasury Regulations governing the accrual method of accounting invalid because cash method ranchers were receiving a tax benefit not afforded to accrual ranchers.

The court held that although respondents had elected the accrual method of accounting, they could nevertheless, contrary to the Regulations, account for their *breeding* animals as if they were on the cash method of accounting—*i.e.*, deduct the costs of raising breeders against ordinary income as incurred and report the full proceeds from the sale of breeders as capital gain—while at the same time continuing to report their gains from the sale of *beef* animals on the accrual method of accounting—*i.e.*, accumulate the costs of raising and offset them against sales proceeds. The court thus permitted respondents to switch to a hybrid method of accounting which gives them both the tax advantages of the cash method (current deduction against ordinary income for the costs of raising breeders) and the accounting advantages of the accrual method (matching of income and expenses on beef animals). This hybrid method allows respondents to match income and expenses when it is to their advantage (*i.e.*, on beef cattle) and to refuse to match income with expenses when they get a tax advantage from deducting such expenses as incurred (*i.e.*, on breeders).

In creating this special hybrid method of accounting for respondents, the lower court completely disregarded the fact that cash method farmers and ranchers are reluctantly allowed to deduct the costs of raising crops and animals as incurred only because that is an unfortunate but essential concomitant of their simplified method of accounting. Since the respondents have elected the more sophisticated accrual method of ac-

counting under which they capitalize the costs of raising their animals, it is incongruous indeed to permit them to dispense with this practice as to their breeding herd while requiring them to maintain it as to their beef herd. See *Little* v. *Commissioner,* 294 F. 2d 661, 663-664 (C.A. 9). Although the Fifth Circuit was "fully cognizant of the anomaly of allowing such tax treatment of a capital asset" (R. 48), that is exactly what it did in the instant cases by holding invalid the Treasury Regulation requiring accrual basis ranchers to capitalize the costs of raising breeding animals.[13]

II.

There Is No Merit to Respondents' Claim That They Have a Right To Use a Hybrid Accounting System Because They Elected the Accrual Method Before the Advent of Capital Gains on Breeding Animals.

Respondents contend that even if both the cash and accrual methods of accounting are proper so that a taxpayer who has willingly elected between them should be required to consistently follow the method selected, nevertheless they should be permitted to change their method of accounting. Respondents' argument goes as follows: They elected the accrual method of accounting before the Service ruled that breeding animals qualified for capital gain treatment. Therefore, at the time they rejected the cash method, they did not realize that at some time in the future cash ranchers would be permitted to deduct the expenses of raising breeders against ordinary income

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[13] As explained *supra* pp. 9-10, fn. 4, the Fifth Circuit stands alone in this regard, two courts of appeals and numerous trial courts having reached the contrary conclusion. Nevertheless, the Fifth Circuit believed itself precluded by principles of *stare decisis* from reexamining its previous ruling on the subject (R. 48, 105).

while accrual ranchers would be required to offset such expenses against capital gains. Consequently, they were never afforded a meaningful choice between the two systems of accounting and should now be permitted to adopt a hybrid method of accounting. We disagree.

A. At least as early as 1924 it was clear that the cash method gave ranchers an immediate deduction for the expenses of raising cattle. See *supra*, pp. 10-11. Respondents, however, in order to obtain a system of record keeping which more accurately reflected their income, chose the accrual method, under which they would defer the costs of raising their animals. There has never been a change in the basic framework of either the cash or accrual methods of accounting. The cash rancher still deducts his raising costs as incurred and reports the full sales proceeds as gain, and the accrual rancher still defers his costs and offsets them against sales proceeds in computing gain from the sale. The only change is that the gains recognized on sales of breeders are now generally taxed as capital gains rather than as ordinary income. However, the way in which the gains are taxed does not alter the basic choice between the two methods of accounting—a choice which respondents have already made. Today, as in 1924, a rancher must still choose between a simple method of accounting which requires a minimum of record keeping and professional assistance and a sophisticated method which more accurately reflects his actual net income.

In the past the very simplicity of the cash method often caused electing taxpayers to receive certain tax advantages, such as an immediate deduction for raising expenses which under good accounting practice

should have been deferred until sale of the animals. Such tax advantages were inherent in any simplified method of accounting. Moreover, such tax advantages were frequently counterbalanced by the cash method's inherent deficiencies in matching income with expenses. The advent of capital gain for raised breeders added another tax advantage to the cash method, but the basic choice remained the same: A farmer or rancher had to choose between the various advantages and disadvantages which are inevitably inherent in the simple cash system of accounting, on the one hand, and a more accurate and sophisticated accrual method of accounting on the other. See *Little* v. *Commissioner,* 294 F. 2d 661 (C.A. 9).

Administration of the tax system would certainly be difficult if every taxpayer were free to modify his accounting system every time there was a change in any of the relative tax advantages of one accounting method over another. Every fluctuation in the rate of tax on ordinary income modifies the tax differential between capital gain and ordinary income, and thus alters the advisability of choosing the cash over the accrual method of livestock accounting. Respondents made the decision between the two principal systems of accounting and the Commissioner is not required to permit them to switch from one method to the other whenever there is a change in one of the variables considered in making the choice.

Congress has given the Commissioner authority to prescribe methods of accounting and has required taxpayers to obtain the Commissioner's consent before making any change in their method of accounting for any material item. See 1954 Code § 446(e); Treas. Reg. § 1.446-1(e)(2)(i); *United States* v. *Ekberg,* 291

F. 2d 913 (C.A. 8), certiorari denied, 368 U.S. 920; *Irvine* v. *United States*, 212 F. Supp. 937 (D. Wyo.). Cf. *Carter* v. *Commissioner*, 257 F. 2d 595 (C.A. 5); *United States* v. *Wardlaw*, R. 105-106. None of the respondents requested the Commissioner's consent to a change in accounting method. The lower court held that respondents need not comply with Code § 446(e)'s requirement that any taxpayer who wishes to change his method of accounting must first "secure the consent of the Secretary [of the Treasury] or his delegate."[14] Its reason was that the Commissioner has consistently denied ranchers' requests to change to the cash method. (*United States* v. *Catto*, R. 48.) The Commissioner has, as a matter of policy, denied such requests where the only reason for the change was to obtain the tax windfall presently permitted to cash method ranchers. In taking that position, however, the Commissioner has not abused his broad discretion over tax accounting methods (*United States* v. *Ekberg, supra*, cf. *Commis-*

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[14] The keystone of tax accounting is consistency from year to year. The Regulations make this general principle specifically applicable to the special methods of accounting available to farmers and ranchers, such as the unit-price-livestock method. Treas. Reg. § 1.471-6(a). Because a change in the accounting treatment of a material item might result in a drastic distortion of income, the Commmissioner is charged with the responsibility of reviewing accounting changes and making sure that the government will not be harmed by any resultant distortion. See *American Can Co.* v. *Commissioner*, 317 F. 2d 604, 606 (C.A. 2), certiorari denied, 375 U.S. 993; *Wright Contracting Co.* v. *Commissioner*, 316 F. 2d 249 (C.A. 5); *Commissioner* v. *O. Liquidating Corp.*, 292 F. 2d 225, 230 (C.A. 3), certiorari denied, 368 U.S. 898; *Broida, Stone & Thomas, Inc.* v. *United States*, 309 F. 2d 486 (C.A. 4), affirming *per curiam* 204 F. Supp. 841 (N.D. W.Va.). The court below permitted respondents to change their method of accounting without seeking the Commissioner's consent, although recognizing that the change would give them "an inordinate deduction against ordinary income in the year in which the correcton is made" (R. 48).

sioner v. *Hansen*, 360 U.S. 446, 467); he is not required to permit changes in accounting methods when a taxpayer's current accounting system clearly and accurately reflects his income and expenses. *Brown* v. *Helvering*, 291 U.S. 193; Treas. Reg. § 1.446-1(c)(2)(ii). Respondents did not even attempt to demonstrate that they had any valid business reason for altering their present accounting practices. Therefore, even assuming *arguendo* that a taxpayer could unilaterally change his accounting system without first seeking the Commissioner's consent where he has established a valid business reason for the change, respondents' suits should have failed.

B. Moreover, we submit that Congress has approved the Commissioner's refusal to permit ranchers who have no valid business reason other than tax avoidance to alter their method of accounting. In 1951 Congress explicitly codified the view that "gains" from sales of breeding animals would be taxed as capital gains. Revenue Act of 1951, § 324, *supra;* now 1954 Code, § 1231(a), (b)(3). The word "gain" is defined by the Code as the excess of the sales proceeds over the accumulated cost or other basis of the property sold. 1954 Code §§ 1001, 1011-1013. Thus, even without a further expression of Congressional intent, a rancher's method of accounting would play an important function in the computation of gain—only those raising expenses that were accumulated instead of being deducted as incurred would be offset against sales proceeds in determining the amount of "gain." The Commissioner had, of course, specifically so ruled as early as 1944. I.T. 3666, *supra.* But Congress was not content to leave such a result to inference. Both the House and Senate Committee Reports to the 1951 legislation (quoted *supra,* p. 14) demonstrate Con-

gress' understanding that the amount of capital gain each rancher would recognize depended on his method of accounting, and Congress' desire that ranchers continue to employ "the method of livestock accounting used * * * and presently recognized by the Bureau of Internal Revenue."

In fact, the next year the Secretary of the Treasury informed Congress that the Commissioner had received a number of requests from ranchers who wished to change from the accrual to the cash method, but that since "the accrual basis now being used by them better reflects their income than the cash basis," the "requests [will] * * * be denied" because they are "not being made for any business reason but solely in order to obtain a tax windfall." (1952 Letter to Congress, R. 13.) Thereafter, Congress declined to amend the Code either to require all ranchers to accumulate the costs of raising breeders or to permit all ranchers to deduct such expenses as incurred. See *supra*, p. 15. Instead, Congress in 1954 reenacted the relevant Code provisions without change.

Thus, we submit (1) that Congress recognized at the time it enacted the 1951 statutory amendment giving capital gain treatment to breeders that cash method ranchers would, because of the necessary simplicity of their accounting system, receive a somewhat greater tax "break" than accrual ranchers; (2) that Congress thereafter refused to eradicate the differential; and (3) that Congress approved the Commissioner's refusal to permit accrual ranchers to switch to the cash method of accounting without a valid business reason.

C. Furthermore, respondents do not, even now, seek to switch from the accrual to the cash method of accounting. They reaffirm their original election of the

more accurate accrual method of accounting and seek to depart from only the aspect of that bookkeeping method relating to breeding animals. Thus respondents are avowedly making no genuine business decision to sacrifice accuracy for simplicity. They are attempting to retain the accuracy of the accrual system of accounting and, at the same time, to obtain the tax advantage which is reluctantly afforded only to those taxpayers who, because of their method of doing business, find simplicity preferable to accuracy. Each method of accounting has its own benefits and burdens. Respondents would combine the advantages of both accounting systems without being subjected to the disadvantages of either. In no event should they be permitted to adopt such a hybrid method of accounting; the Commissioner is not required to accept such a material departure from respondents' over-all accrual method. *Niles Bement Pond Co.* v. *United States,* 281 U.S. 357, 360; *Commissioner* v. *Hansen,* 360 U.S. 446; *Iverson's Estate* v. *Commissioner,* 255 F. 2d 1 (C.A. 8), certiorari denied, 358 U.S. 893; *Banks* v. *Commissioner,* 322 F. 2d 530, 546-547 (C.A. 8); *SoRelle* v. *Commissioner,* 22 T.C. 459.[15]

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[15] There are two additional reasons why the decision of the lower court is wrong as to certain of the respondents:

(1). Both respondents in *Catto* and five of the eight respondents in *Wardlaw* filed their original tax returns for the years in question according to the method of accounting for raised breeders here advocated by the Commissioner (which they had also consistently used in prior years). These respondents later attempted to change their method of accounting for raised breeders retroactively by filing claims for refund. (R. 5, 6, 57-59) Even a permissible change in accounting methods cannot be made after the original return has been filed. *Pacific National Co.* v. *Welch,* 304 U.S. 191, 193-194.

(2). It is evident from the record that the respondents in *Catto* did have an opportunity to change from the accrual to the cash

III.

The Unit-Livestock-Price Variant of the Accrual Method of Accounting Is an Acceptable Method of Computing the Amount of Raising Costs Which Are To Be Deferred Pending Sale of the Animals.

Respondents have at times suggested that the Regulations here in question are invalid because of the way in which they require a rancher who has elected the unit-livestock-price variant of the accrual method of

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method of accounting after it had become clear that breeding cattle were subject to capital gain treatment. Respondent Roxana Catto and her sister inherited two ranches which they operated as a partnership. Between 1948 and 1951 they terminated the partnership and partitioned the lands between respondent Roxana Catto and her sister. Thereafter, Roxana Catto conducted ranching operations on her portion of the land as a sole proprietor. (R. 2).

When (as here) a partnership is dissolved and its business assets divided among the partners, so that each operates a fragment of the old business, the resulting sole proprietorships are sufficiently different from the old partnership's business, to entitle each former partner to elect a new method of accounting. Treas. Reg. § 1.446-1 (d), (e); cf. *J.A. Biewer Estate* v. *Commissioner*, 341 F. 2d 394 (C.A. 6); *Ezo Products Co.* v. *Commissioner*, 37 T.C. 385. See also Treas. Reg. § 1.703-1(b), which regards a partnership as an entity distinct from the individual partners for purposes of electing methods of accounting. Therefore, at the time the Catto partnership terminated and respondent for the first time began business operations as a sole proprietor, she was free to select either the cash or accrual method of accounting. Treas. Reg. § 1.446-1(d). Respondents argued below that a 1945 unpublished letter ruling (1945 CCH Fed Tax Service, vol. 4, para. 6129) precluded them from changing their method of accounting when the partnership was dissolved. That ruling is clearly inapposite. There a sole proprietor accepted a new investor as a partner. Since there was no substantial change in the business, the Commissioner ruled that the partnership could not elect a new method of accounting. In the instant case, the partnership business assets were split between the two sisters and thereafter each carried on a business materially different from the partnership business. Since, at the time the Catto partnership was liquidated, it was clear that profits from

accounting (as have all of the respondents[16]) to defer the costs of raising cattle. In answer to those contentions, we will explain the functioning of the unit-livestock-price method and demonstrate that it is a perfectly acceptable accrual method of accounting for raised livestock and in harmony with the relevant provisions of the Code.

If a rancher elects the accrual rather than the cash method of accounting, he is required by the Regulations to defer the cost of raising his animals and offset the accumulated raising costs against the proceeds received when the animals are sold. Treas. Reg. §§ 1.61-4(b), 1.167(a)-6(b), 1.471-6(f).[17] If a taxpayer were able

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the sale of breeders constituted capital gain, the Catto respondents have been afforded a meaningful choice.

Moreover, similar reasoning may also apply to one of the *Wardlaw* respondents. Although the district court granted summary judgment for the respondents, the record does not contain sufficient facts regarding respondent B. E. Wilson, who apparently entered into a partnership for the first time in 1948 (R. 54), to permit a decision on whether the partnership could at that time have selected the cash method of accounting. See Treas. Reg. § 1.703-1(b).

[16] The Treasury Regulations did not specifically discuss the unit-livestock-price method until 1944. T.D. 5423, 1945 Cum. Bull. 70. However, many ranchers (including the respondents (R. 3-4, 56)) had for many years used the same method—which was then variously called the "constant price" method, the "unit price" method, or the "unit-livestock-price" method. See Mim. 5790, 1945 Cum. Bull. 72. When the Regulations were amended in 1944 to describe the unit-livestock-price method, all accrual taxpayers who had previously been using such a method to report income were required to continue on the unit-livestock-price method. T.D. 5423, *supra;* Treas. Reg. § 1.471-6(h).

[17] Under the accrual method the cost of raising a breeder to maturity, like the costs of building a machine, must be capitalized. However, the costs of maintaining the breeder after it matures and is put into service (such as feed, etc.), like the costs of maintaining and repairing a machine which is in production (*e.g.*, oil, spare parts, etc.), may be deducted as incurred.

to ascertain which costs were incurred with respect to each physical asset produced, he would defer only those incurred with respect to assets still on hand at the end of the tax year and deduct against the proceeds of sale those incurred with respect to assets sold during the tax year. However, in ranching and farming, as in most other industries, it is usually impossible to assign each cost incurred to a particular physical asset. Therefore, an estimated-cost approach is usually employed. The key to such a system is the valuation of assets (here cattle) on hand at the end of the tax year. If realistic estimates are used, an estimated-cost system should reach the same result as an actual cost method without requiring extensive and complex record-keeping devices.

The "unit-livestock-price" method is just such an estimated cost system designed especially for livestock raisers. If a taxpayer elects to use the "unit-livestock-price" method, he estimates the amount it costs him to raise his different types of livestock to various stages of development and establishes a "standard unit price" for each age level of a particular class of livestock. Treas. Reg. § 1.471-6(e). At the beginning of the year in which the rancher first adopts unit pricing, he counts the number of head on hand in each class and values them according to his established estimates (which will remain constant from year-to-year unless there is a sharp rise in costs). This is his opening inventory. At the end of the year he similarly counts and values his livestock on hand to arrive at closing inventory (which, of course, will also be opening inventory for the succeeding year). Treas. Reg. § 1.471-6(f); Mim. 5790, 1945 Cum. Bull. 72. The rancher then computes his income for a given year as follows: Opening in-

ventory represents raising costs incurred in previous years but not deducted because allocable to animals which were still on hand at the end of the previous year (*i.e.*, the beginning of this year). The total of opening inventory and the raising expenditures incurred during the current tax year represent costs incurred by the taxpayer (both that year and in previous years) but not yet deducted. Closing inventory represents the costs which are to be deferred until later tax years because allocable to animals still on hand at the year end. Therefore, the total of opening inventory and raising expenses incurred during the current year less closing inventory equals the amount of costs allocable to animals sold during the year in question. This amount is deducted from gross income. Treas. Reg. §§ 1.61-4(b), 1.162-12.

For an illustration of how this method works, assume that a livestock raiser estimates that it costs him $10 per year to raise an animal to maturity. Suppose that at the beginning of the year he had on hand 10 one-year-olds. His opening inventory would therefore be valued at $100. Assume, also, that he expended $100 in raising these animals during the year and sold none of them. Therefore, at the year's end the rancher would have incurred a total of $200 of expenditures which he had not yet deducted: $100 spent in the current year, plus $100 spent in previous years and deferred because the cattle had not yet been sold. His closing inventory would be $200 (10 × $20), and his gain or loss for the year would be computed as follows:

Sales		$0
Costs of Goods Sold:		
Opening inventory	$100	
Expenditures for feed, etc.	$100	
	200	
Less: Closing inventory	200	
		$0
Profit		$0

Thus, to the extent the taxpayer estimates that his cattle on hand at the end of the year cost him more than the cattle he had on hand at the beginning of the year, his raising costs incurred during the year are deferred. To this extent his costs are accumulated in the closing inventory account and carried forward as the cost basis of the goods on hand for the succeeding year (*i.e.*, opening inventory for the next year is $200).[18]

Expenditures incurred in raising breeders are almost identical in kind to those incurred in raising beef cattle; in fact the two classes of livestock are usually kept in the same herd until a certain age is reached. It is virtually impossible to separate the costs incurred with respect to breeding animals from the general pool of raising expenditures. Consequently, the Regulations

[18] The Regulations explain the mechanics of computing income somewhat differently than stated above. However, the result is the same. The Regulations state that the taxpayer should add closing inventory to income and subtract both opening inventory and expenditures incurred during the year. Treas. Reg. §§ 1.61-4(b), 1.162-12. This, of course, reaches exactly the same result explained above: It reduces the deduction for expenditures incurred during the year by the increase in inventory, *i.e.*, by the amount of the expenditures which has been accumulated in inventory and deferred until the animals are sold.

require ranchers who use the unit-livestock-price method of deferring the costs of raising beef cattle to apply the same method to their breeding animals. Treas. Reg. § 1.471-6(f). As a practical matter this generally means that a taxpayer includes his raised breeders in his inventory.[19] This procedure does not, however, prevent the rancher from reporting the gain on sale of breeders as capital gain; it merely requires that he use the unit-livestock-price method of estimating the amount of raising costs which will be deferred and deducted against sales proceeds in computing gain. In fact, the Commissioner ruled as early as 1944 that a rancher is entitled to capital gain on sales of breeders regardless of how he computes their cost basis and regardless of whether he includes them in inventory for accounting convenience.[20] I.T. 3666, 1944 Cum. Bull. 270.

Respondents have argued that the Regulations are invalid because they require an accrual method rancher to add increases in the inventory value of breeders to ordinary income. As explained, *supra*, p. 29, fn. 18, the requirement that closing inventory be added to income and opening inventory be subtracted from income must be viewed along with the requirement that raising expenses incurred during the year also be deducted from income. See Treas. Reg. §§ 1.61-4(b), 1.162-12. The net effect of these three steps is to defer the ex-

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[19] While the Regulations do not require him to include raised breeders in inventory, at least one ruling assumes that he will do so. Mim. 5790, 1945 Cum. Bull. 72.

[20] Indeed, although given a choice by the Regulations (Treas. Reg. §§ 1.471-6(g), 1.61-4(b)), a number of the respondents made a binding election to include their *purchased* breeders in inventory for accounting convenience (R. 105-106).

penses incurred that year to the extent inventory has increased and permit an immediate deduction of only the excess.[21] So viewed, it is clear that these mechanics do not deprive respondents of any capital gain; they merely result in deferral of the costs properly allocable to breeding cattle so that these costs may be deducted against the proceeds from the sale of such animals.

Assume, for example, that the estimated cost of a rancher's beef and breeding cattle on hand at the beginning of the year was $100, that he expended $100 in raising those animals during the year, and that the estimated cost of his unsold cattle at the end of the year was $140. Since his inventory increased by $40, it means that $40 of the $100 expended during the year had been deferred, *i.e.*, added to the cost basis of beef and breeding cattle on hand at the end of the year. The other $60 represents the costs of raising the cattle which were sold, and is accordingly to be deducted from the proceeds of sale to determine gain, capital or ordinary depending on whether the animals sold were breeding or beef cattle. Internal Revenue Code of 1954, §§ 1001, 1011-1013, 1016.[22]

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[21] The stipulation of facts in the *Wardlaw* case recognizes that this is the actual effect of the mechanics explained in the Regulations (R. 67-68).

[22] In practice, the inventory mechanics differ slightly with respect to beef and breeding cattle. Since opening inventory includes both beef and breeding animals and since opening inventory is in effect deducted from ordinary income to compute ordinary gain, those breeders which have been sold must be removed from opening inventory in order to avoid a double deduction: Once in computing the amount of capital gain and again in computing ordinary income. *Gibbs* v. *Commissioner*, 33 T.C. 27; *Little* v. *Commissioner*, 34 T.C. 156, affirmed, 294 F. 2d 661 (C.A. 9). See also R. 68.

Therefore, the Regulations merely require taxpayers who have chosen the unit-livestock-price method of valuing their inventory of beef cattle, to employ the same method in valuing their breeding cattle, *i.e.*, to use the same method in deciding the amount of costs to be deferred rather than deducted with respect to breeding as well as beef cattle. Treas. Reg. 1.471-6(f). When a breeder is sold, the excess of the sales proceeds over the animal's deferred cost basis will, of course, constitute capital gain. Thus, the unit-livestock-price method is merely a way of estimating the amount of the expenditures which will be deferred—both with respect to beef and breeding cattle—and does not affect the rancher's right to capital gain on the sale of breeders.[23] A procedure

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[23] In general the Treasury Regulations permit accrual basis ranchers to depreciate either purchased or raised breeding cattle used in their trade or business. Beginning with a breeding animal's maturity a rancher, under generally accepted principles, is permitted to depreciate the excess of its cost basis over its estimated salvage value. Treas. Reg. §§ 1.61-4(b), 1.167(a)-6(b). However, because breeding animals can be sold for their beef value at the end of their useful lives as breeders, the cost of raising a breeding animal almost always approximates or is less than its estimated salvage value. This is especially true of those taxpayers who use the unit-livestock-price method of valuing their cattle; standard unit costs (used to value cattle on hand) have remained constant over the years while actual costs and salvage values have risen because of inflation. Thus as a practical matter only purchased breeders (for which thousands of dollars are sometimes paid) are depreciable, and raised breeders (for which at most a few hundred dollars of raising costs are expended) are not. This explains the ruling which prohibits a rancher who elected the unit-livestock-price method of accrual accounting from depreciating his raised breeders. I.T. 3712, 1945 Cum. Bull. 176; Mim. 5790, 1945 Cum. Bull. 72. Cf. Treas. Reg. 1.61-4(b). The prohibition merely prevents him from depreciating raised breeding cattle, which as a practical matter he could not have depreciated anyway, and has no other effect. In any event, none of the respondents seeks to depreciate raised breeders.

which is a proper means of deferring the costs of producing beef cattle cannot be inappropriate when applied to breeding cattle for the same purpose.

CONCLUSION

The judgments of the court of appeals should be reversed.

Respectfully submitted.

THURGOOD MARSHALL,
Solicitor General.

C. MOXLEY FEATHERSTON,
Acting Assistant Attorney General.

JACK S. LEVIN,
Assistant to the Solicitor General.

MELVA M. GRANEY,
MARTIN T. GOLDBLUM,
Attorneys.

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APPENDIX

Internal Revenue Code of 1954:

SEC. 446. GENERAL RULE FOR METHODS OF ACCOUNTING.

* * * *

(e) *Requirement Respecting Change of Accounting Method.*—Except as otherwise expressly provided in this chapter, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary or his delegate.

(26 U.S.C. 446.)

SEC. 1001. DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis * * *.

(26 U.S.C. 1001(a).)

SEC. 1012. BASIS OF PROPERTY—COST.

The basis of property shall be the cost of such property, except as otherwise provided * * *

(26 U.S.C. 1012.)

SEC. 1013. BASIS OF PROPERTY INCLUDED IN INVENTORY.

If the property should have been included in the last inventory, the basis shall be the last inventory value thereof.

(26 U.S.C. 1013.)

SEC. 1016. ADJUSTMENTS TO BASIS.

(a) *General Rule.*—Proper adjustment in respect of the property shall in all cases be made—

(1) for expenditures, receipts, losses, or other items, properly chargeable to capital account * * *

(26 U.S.C. 1016.)

SEC. 1231. PROPERTY USED IN THE TRADE OR BUSINESS AND INVOLUNTARY CONVERSIONS.

(a) *General Rule.*—If, during the taxable year, the recognized gains on sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. * * *

* * * *

(b) *Definition of Property Used in the Trade or Business.*—For purposes of this section—

* * * *

(3) *Livestock.*—Such term also includes livestock, regardless of age, held by the tax-

payer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition. Such term does not include poultry.

* * * *

(26 U.S.C. 1231.)

Treasury Regulations on Income Tax (1954 Code):

§ 1.61-4 *Gross income of farmers.*

(a) *Farmers using the cash method of accounting.* A farmer using the cash receipts and disbursements method of accounting shall include in his gross income for the taxable year—

(1) The amount of cash and the value of merchandise or other property received during the taxable year from the sale of livestock and produce which he raised,

(2) The profits from the sale of any livestock or other items which were purchased,

(3) All amounts received from breeding fees, fees from rent of teams, machinery, or land, and other incidental farm income,

(4) All subsidy and conservation payments received which must be considered as income, and

(5) Gross income from all other sources.

The profit from the sale of livestock or other items which were purchased is to be ascertained by deducting the cost from the sales price in the year in which the sale occurs, except that in the case of the sale of purchased animals held for draft, breeding, or dairy purposes, the profits

shall be the amount of any excess of the sales price over the amount representing the difference between the cost and the depreciation allowed or allowable (determined in accordance with the rules applicable under section 1016(a) and the regulations thereunder). * * *

(b) *Farmers using an accrual method of accounting.* A farmer using an accrual method of accounting must use inventories to determine his gross income. His gross income on an accrual method is determined by adding the total of the items described in sub-paragraphs (1) through (5) of this paragraph and subtracting therefrom the total of the items described in sub-paragraphs (6) and (7) of this paragraph. These items are as follows:

(1) The sales price of all livestock and other products held for sale and sold during the year;

(2) The inventory value of livestock and products on hand and not sold at the end of the year;

(3) All miscellaneous items of income, such as breeding fees, fees from the rent of teams, machinery, or land, or other incidental farm income;

(4) Any subsidy or conservation payments which must be considered as income;

(5) Gross income from all other sources;

(6) The inventory value of the livestock and products on hand and not sold at the beginning of the year; and

(7) The cost of any livestock or products purchased during the year (except livestock held for

draft, dairy, or breeding purposes, unless included in inventory).

All livestock raised or purchased for sale shall be added in the inventory at their proper valuation determined in accordance with the method authorized and adopted for the purpose. Livestock acquired for draft, breeding, or dairy purposes and not for sale may be included in the inventory (see subparagraphs (2), (6), and (7) of this paragraph) instead of being treated as capital assets subject to depreciation, provided such practice is followed consistently from year to year by the taxpayer. When any livestock included in an inventory are sold, their cost must not be taken as an additional deduction in computing taxable income, because such deduction is reflected in the inventory. See the regulations under section 471. * * *

(c) *Special rules for certain receipts.* In the case of the sale of machinery, farm equipment, or any other property (except stock in trade of the taxpayer, or property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business), any excess of the proceeds of the sale over the adjusted basis of such property shall be included in the taxpayer's gross income for the taxable year in which such sale is made. * * *

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§ 1.162-12 *Expenses of farmers.*

A farmer who operates a farm for profit is entitled to deduct from gross income as necessary

expenses all amounts actually expended in the carrying on of the business of farming. The cost of ordinary tools of short life or small cost, such as hand tools, including shovels, rakes, etc., may be deducted. The purchase of feed and other costs connected with raising livestock may be treated as expense deductions insofar as such costs represent actual outlay, but not including the value of farm produce grown upon the farm or the labor of the taxpayer. * * * Amounts expended in purchasing work, breeding, or dairy animals are regarded as investments of capital, and may be depreciated unless such animals are included in an inventory in accordance with § 1.61-4. * * *

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§ 1.167(a)-6 *Depreciation in special cases.*

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(b) *Depreciation in cases of farmers.* A reasonable allowance for depreciation may be claimed on farm buildings (except a dwelling occupied by the owner), farm machinery, and other physical property but not including land. Livestock acquired for work, breeding, or dairy purposes may be depreciated unless included in an inventory used to determine profits in accordance with section 61 and the regulations thereunder. Such depreciation should be determined with reference to the cost or other basis, salvage value, and the estimated useful life of the livestock. * * *

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§ 1.446-1 *General rule for methods of accounting.*

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(e) *Requirement respecting the adoption or change of accounting method.* * * *

(2) (i) Except as otherwise expressly provided in chapter 1 of the Code and the regulations thereunder, a taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. A change in the method of accounting includes a change in the over-all method of accounting for gross income or deductions, or a change in the treatment of a material item. Consent must be secured whether or not a taxpayer regards the method from which he desires to change to be proper. Thus, a taxpayer may not compute his taxable income under a method of accounting different from that previously used by him unless such consent is secured.

* * * *

§ 1.471-6 *Inventories of livestock raisers and other farmers.*

(a) A farmer may make his return upon an inventory method instead of the cash receipts and disbursements method. It is optional with the taxpayer which of these methods of accounting is used but, having elected one method, the option so exercised will be binding upon the taxpayer for the year for which the option is exercised and for subsequent years unless another method is authorized by the Commissioner as provided in paragraph (e) of § 1.446-1.

(b) In any change of accounting method from the cash receipts and disbursements method to an inventory method, adjustments shall be made as provided in section 481 (relating to adjustments required by change in method of accounting) and the regulations thereunder.

(c) Because of the difficulty of ascertaining actual cost of livestock and other farm products, farmers who render their returns upon an inventory method may value their inventories according to the "farm-price method", and farmers raising livestock may value their inventories of animals according to either the "farm-price method" or the "unit-livestock-price method".

(d) The "farm-price method" provides for the valuation of inventories at market price less direct cost of disposition. If this method of valuing inventories is used, it must be applied to the entire inventory except as to livestock inventoried, at the taxpayer's election, under the "unit-livestock-price method". If the use of the "farm-price method" of valuing inventories for any taxable year involves a change in method of valuing inventories from that employed in prior years, permission for such change shall first be secured from the Commissioner as provided in paragraph (e) of § 1.446-1.

(e) The "unit-livestock-price method" provides for the valuation of the different classes of animals in the inventory at a standard unit price for each animal within a class. A livestock raiser electing this method of valuing his animals must adopt a reasonable classification of the animals in his inventory with respect to the age and kind included so that the unit prices assigned to the several classes will reasonably account for the normal costs incurred in producing the animals within such classes. Thus, if a cattle raiser determines that it costs approximately $15 to produce a calf, and $7.50 each year to raise the calf to maturity, his classifications and unit

prices would be as follows: Calves, $15; yearlings, $22.50; 2-year olds, $30; mature animals, $37.50. The classification selected by the livestock raiser, and the unit prices assigned to the several classes, are subject to approval by the district director upon examination of the taxpayer's return.

(f) A taxpayer who elects to use the "unit-livestock-price method" must apply it to all livestock raised, whether for sale or for draft, breeding, or dairy purposes. Once established, the unit prices and classifications selected by the taxpayer must be consistently applied in all subsequent taxable years in the valuation of livestock inventories. No changes in the classification of animals or unit prices will be made without the approval of the Commissioner.

(g) A livestock raiser who uses the "unit-livestock-price method" must include in his inventory at cost any livestock purchased, except that animals purchased for draft, breeding, or dairy purposes can, at the election of the livestock raiser, be included in inventory or be treated as capital assets subject to depreciation after maturity. If the animals purchased are not mature at the time of purchase, the cost should be increased at the end of each taxable year in accordance with the established unit prices, except that no increase is to be made in the taxable year of purchase if the animal is acquired during the last six months of that year. If the records maintained permit identification of a purchased animal, the cost of such animal will be eliminated from the closing inventory in the event of its sale or loss. Otherwise, the first-in, first-out method of valuing inventories must be applied.

(h) If a taxpayer using the "farm-price method" desires to adopt the "unit-livestock-price method" in valuing his inventories of livestock, permission for the change shall first be secured from the Commissioner as provided in paragraph (e) of § 1.446-1. However, a taxpayer who has filed returns on the basis of inventories at cost, or cost or market, whichever is lower, may adopt the "unit-livestock-price method" for valuing his inventories of livestock without formal application for permission, but the classifications and unit prices selected are subject to approval by the district director upon examination of the taxpayer's return. A livestock raiser who has adopted a constant unit-price method of valuing livestock inventories and filed returns on that basis will be considered as having elected the "unit-livestock-price method".

(i) If returns have been made in which the taxable income has been computed upon incomplete inventories, the abnormality should be corrected by submitting with the return for the current taxable year a statement for the preceding taxable year. In this statement such adjustments shall be made as are necessary to bring the closing inventory for the preceding taxable year into agreement with the opening complete inventory for the current taxable year. If necessary clearly to reflect income, similar adjustments may be made as at the beginning of the preceding year or years, and the tax, if any be due, shall be assessed and paid at the rate of tax in effect for such year or years.

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